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CONTRACTS COMPLICATE FRAMEWORK LAW NEGOTIATIONS

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would not/not go to Iran. Instead, the pipeline would run south by southeast well within the Iraqi side of Iraq-Iran border, approximately from Diyala province to Basrah. END NOTE)

¶6. (SBU) Indicative of relations between the GOI and the KRG, no KRG representative--such as Dr. Ashti Hawrami, KRG Minister of Natural Resources--attended the conference. Moreover, Shahristani mentioned no Ministry of Oil (MoO) plans for the north. Further evincing a lack of coordination, in response to a question regarding whether KRG investments were included in a MoO report on refineries, Shahristani replied in the negative and said that the MoO simply distributes funds to the KRG for it to spend as it sees fit.

THE GOI'S ENVISAGED ROLE FOR IOCS IN IRAQ

¶6. (SBU) Shahristani made clear that the GOI welcomes IOC investment in Iraq and that IOC technology, expertise, training, and capital would be crucial to the GOI's strategy for developing its decrepit oil industry. With the sector's physical and human capital badly degraded by years of war, sanctions, mismanagement, and terrorist attacks, Shahristani emphasized that the GOI would embrace those IOCs interested not just in finding and producing crude, but also in improving Iraq's infrastructure and human resources for the long term, through investment, technology transfer, and intensive training of Iraqi personnel. Shahristani stressed that the overarching principles governing IOC participation in Iraq's petroleum sector would be that it (a) maximize economic benefit for the Iraqi people and (b) preserve Iraqi sovereignty over its hydrocarbon natural resources. In short, he said, IOC participation will complement, not displace, the GOI's own efforts to develop its oil industry.

¶7. (SBU) Though key elements of the HFL remain to be negotiated, and model contracts to serve as a starting point with IOCs are in their draft stages, Shahristani sketched how the GOI foresees IOCs participating in Iraq's petroleum sector. Supported by Natik al-Bayati, former MoO Director General (DG) of Reservoir and Oil Fields Development and now

DG of Contracting and Licensing, Shahristani outlined the types of agreements the GOI would favor and the contracting process contemplated by the current draft framework law. The two men expressed a decided preference for service contracts instead of PSCs. (NOTE: IOCs generally prefer PSCs because they enable the firms to take title to a share of the reserves covered in the agreement and book them as assets; booking reserves strengthens the firms' balance sheets and, among other things, allows them to borrow funds more cheaply. Some governments prefer service contracts, in which the government simply pays the IOC a fee for services, because they--or their constituents--associate PSCs with "giving up sovereignty" over the country's natural resources. END NOTE)

¶8. (U) Shahristani said the near-term focus for IOC participation would be to increase production from fields already operating through service contracts signed with the competent authority for the field in question: the MoO, a regional authority (i.e., the KRG), or the yet to be created Iraq National Oil Company (INOC). (NOTE: The draft framework law would not create INOC; separate legislation not yet presented to the CoR would be needed to do so. END NOTE) Shahristani implied that with comparatively modest IOC investment--e.g., introducing new reservoir management techniques, technologies, best practices, and infrastructure improvements--Iraq could meet its short-term production goals. For medium- and long-term targets the emphases would be (a) developing, and producing from, discovered but dormant fields and (b) exploring new blocs. In this longer-term context, which entails greater risk for the IOCs, Bayati conceded that the GOI might consider a form of PSC.

¶9. (SBU) Despite their clear preference for service contracts, Shahristani and Bayati were at pains to assure IOCs that the GOI would address the firms' interests, noting that the draft HFL states that contracts should provide an "appropriate return on investment to the investor." (NOTE: In addition to the ability to book reserves, IOCs prefer legal regimes and contracts that (a) align the interests of the firm and the government under variable international oil price scenarios, (b) accord the firms a reasonable degree of managerial control over operations, and (c) establish a clear tax and regulatory environment. END NOTE) Bayati stated that the GOI foresaw IOCs forming joint-ventures with INOC, or a subsidiary thereof, in which the Iraqi participant took no more than a 50 percent interest. The joint-venture agreement

would provide a framework for the relationship, and the IOC would receive remuneration, pursuant to an underlying "improved service contract," in cash or kind (i.e., oil) depending upon the firm's investment. (NOTE: Repeated conversations with IOC executives established that, while they preferred straight PSCs, joint-ventures combined with service agreements and the right terms could also satisfy their concerns. END NOTE)

¶10. (SBU) Bayati explained that under the draft HFL, a new body, the Federal Oil and Gas Council (FOGC) would set broad petroleum policies, establish priorities for blocs and fields in licensing rounds, draft model contracts, promulgate contract negotiation guidelines, and (perhaps most controversially) approve or reject contracts signed by the MoO, INOC, and the regional authorities. The FOGC would be comprised of the Prime Minister, the Oil, Finance, and Planning Ministers, the Central Bank Governor, representatives of the regions and oil-producing governorates, the DGs of INOC and its subsidiaries, and three outside experts.

¶11. (U) Notwithstanding all the discussion of the draft framework law, Shahristani stated several times that there is "no legal vacuum" in Iraq with respect to oil: IOCs interested in signing agreements before the HFL is approved may do so under Saddam-era legislation and, if necessary,

such a contract would be brought into line with the HFL once passed. (NOTE: The existing law requires parliamentary approval of all contracts, an unattractive feature to most potential investors. END NOTE) Similarly, in response to a question from an attendee, Shahristani also said that passing the HFL need not await Iraq's constitutional review process because the law could be brought into line with any pertinent amendments to the constitution that may come to pass.

OIL MINISTER COURTING ALREADY ENAMORED IOCS

¶12. (C) Repeated conversations with representatives from all the major IOCs and an array of smaller firms made clear that, despite the legal uncertainties and ongoing security challenges, they are eager to sign deals in Iraq. In the words of one, "Iraq is in play." Given (a) the enormity of its proven reserves (the world's third largest, at 115 billion barrels), (b) the recognized potential for that figure to grow substantially with more exploration, and (c) its paltry present level of production (the world's lowest production to reserves ratio), Iraq is the darling of the international oil industry. According to one major IOC executive, "we simply must be there." Queried by Econoffs whether an approved HFL would be a necessary condition precedent to signing agreements or actually beginning work in Iraq, a common IOC response was: "We would prefer one, of course, but no. Not necessary. We could work out any issues that came up when the law gets passed." What about improved security conditions? "We would prefer it, but we can always buy security." (COMMENT: Behind this cavalier sounding perspective lies extensive IOC experience operating in legally murky, dangerous environments, e.g., Nigeria, Angola, and Indonesia, and the long-term, capital-intensive nature of their investments: years to start up, billions to put in place, and decades to amortize. END COMMENT)

¶13. (C) Large and small firms do, however, have differently nuanced assessments of the appropriate timing and strategy for their entry into Iraq. While the major IOCs--e.g., Exxon Mobil, Chevron, BP, Shell, and ConocoPhillips--expressed interest in signing deals for Iraq projects in the coming months, none were enthusiastic about putting their staff in the country immediately. Their eagerness to do deals, however, stemmed from a desire to begin the months-long process of drafting work programs, engineering plans, and the like, which their staffs can do outside Iraq. Given the technical sophistication and capital intensiveness of their investments, and their comparatively high profile, major IOCs generally presented themselves to Econoffs as marginally more risk averse than their smaller competitors.

¶14. (C) Smaller IOCs, on the other hand, see their window of opportunity closing quickly. More nimble and less capital intensive, several small IOCs told Econoffs that their play for the Iraqi market is to be more risk tolerant and sign smaller deals now, for example, to boost production from a smaller already operating field, or to develop a smaller discovered but dormant one. By entering the market now with comparatively minor capital investment, they could sell their operation at a premium to a major firm in the coming years or, depending on the circumstances, remain in Iraq as an independent operator. (COMMENT: In light of Shahristani's

priorities, the GOI might be less interested in investment from smaller companies because they would be less equipped to offer state-of-the-art technologies and long-term training programs for Iraqi personnel. But, if such firms are willing to put personnel in Iraq now, the GOI might welcome their assistance in meeting its short-term production goals. END COMMENT)

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KRG DEALS WITH IOCS FURTHER COMPLICATE HFL NEGOTIATIONS

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¶15. (C) The conference buzzed with news that the KRG signed a PSC with Hunt Oil Company--a leading, mid-size, privately held U.S. firm--and Impulse Energy Corporation, pursuant to the KRG's recently approved regional oil and gas law (reftel). (NOTE: Roy Hunt, Hunt's Chief Executive and President, has ties to the White House, a point upon which some media outlets have seized. END NOTE) The PSC covers exploration activities in the Dahuk area of the Kurdistan Region. According to a KRG press release, Hunt Oil Company of the Kurdistan Region, a wholly owned Hunt affiliate, will serve as operator under the agreement and begin geological surveys and seismic work before the end of the year. The KRG had previously signed agreements with smaller firms--e.g., DNO of Norway, Genel Enerji of Turkey, and Western Oil Sands of Canada--but this was the first under its new oil and gas law and the first with a U.S. company.

¶16. (C) Shahristani hastened to declare that all such agreements have "no standing" as far as the GOI is concerned and later said such contracts were "illegal" until reviewed and approved by the "federal authority." (NOTE: Shahristani's reference to the "federal authority" appears to refer to the FOGC foreseen in the draft HFL. Among the more contentious issues in the HFL negotiations is the FOGC's role in overseeing regional petroleum activities. END NOTE) The KRG quickly and publicly issued a sharp rebuke of Shahristani's comments and called for his resignation from the government, challenging his authority to question the legitimacy of contracts awarded by the KRG.

¶17. (C) The announcement of the KRG-Hunt deal led executives from Shell Oil Company to approach Econoffs and report that Shell too was in negotiations with the KRG. The executives stated that they are considering signing a memorandum of understanding (MOU) with the KRG for an exploration bloc in the Kurdistan Region; the parties would convert the MOU to a PSC upon CoR approval of the HFL. The executives asked whether the USG would view a deal favorably or not. Econoffs advised them that the USG position has been that signing deals before the CoR approves the HFL further complicates negotiations and undermines efforts to pass the law. The Shell reps said that they would advise Econoffs of any developments. (NOTE: Statoil of Norway likewise sought the USG position about a similar deal with the KRG months ago, and USG officials gave the firm the same response. Media have reported rumors of a KRG-Statoil agreement. END NOTE)

COMMENT

¶17. (C) The HFL continues to be the subject of intense negotiations, and the security conditions make investing in Iraq costlier than it otherwise would be. The GOI and the IOCs are nonetheless eager to sign agreements to lay the foundations for developing Iraq's petroleum sector: the undisputed key to Iraq's economic recovery and an important factor in its process of political reconciliation. The most recent known iteration of the HFL, if approved, would be a significant step toward creating a modern regulatory environment under which both the GOI and IOCs could sign contracts that address their respective interests. The CoR's approval of the HFL thus remains a key USG policy objective because of its centrality to political reconciliation in Iraq.

¶18. (C) KRG deals with IOCs make negotiations on the HFL more difficult. By signing PSCs in particular, the KRG puts pressure on the GOI to take a more accommodating posture in its own negotiations with IOCs; the firms might be less willing to accept straight service contracts, the GOI's stated preference, given the precedent set by the Kurds. In addition, creating facts on the ground before the party leaders in Baghdad have worked through the thorniest issues the HFL brings to the fore--fundamentally, the power relationships between the GOI and the regions--heats up the negotiating environment and makes reasoned compromise harder

to reach. Moreover, the Hunt deal in particular badly undercuts the USG's position of encouraging IOCs to be patient and exercise restraint while the HFL negotiations

proceed. The KRG-Hunt deal was big, but a Shell or Statoil deal would be even bigger. More KRG-IOC deals will likely further delay, and perhaps derail, progress toward a key USG policy objective.
BUTENIS